# SUPPLIER-DISTRIBUTOR RELATIONSHIPS: FRANCHISE LAWS

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***PRESENTATION TO***

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# *Why Should Liquor Administrators Care About Franchise Laws?*

- A few states specifically charge liquor regulators with the responsibility to enforce beer franchise laws and similar laws regulating the supplier/distributor relationship.

- Even in the absence of such responsibility, liquor administrators should recognize that beer franchise laws play a key role in the effectiveness of tied-house and three tier laws. They also play a key role in guaranteeing access to market, particularly for small suppliers.

- Franchise laws followed employment, securities, banking, insurance, and other regulations promulgated to temper abuses in the free-market economy. The need for such regulation unequivocally persists. Our experiences with AIG, Enron, WorldCom, Madoff, and the recent Wall Street financial crisis serves as a reminder that we need more, not less, regulation in certain critical or socially sensitive parts of our economy.

# The Three Franchise Law Models


- General Franchise Law Requirements
  - An agreement, written or oral, by which a franchisee is granted the right to engage in the sale or distribution of goods or services using the franchisor's trade name and trademarks.
  - The franchisor and franchisee have a "community of interest" in the marketing of goods or services.
  - The franchisee pays the franchisor a "**franchise fee**".
- Fair Dealing Law Requirements
  - An agreement, written or oral, by which a dealer is granted the right to engage in the sale or distribution of goods or services using the supplier's trade name and trademarks.
  - The supplier and the dealer have a "community of interest".
  - No "**franchise fee**" requirement.
- Industry Specific Franchise Law Requirements (Alcohol).
  - An agreement, written or oral, between an alcohol supplier and distributor.
  - No "community of interest" or "franchise fee" requirement

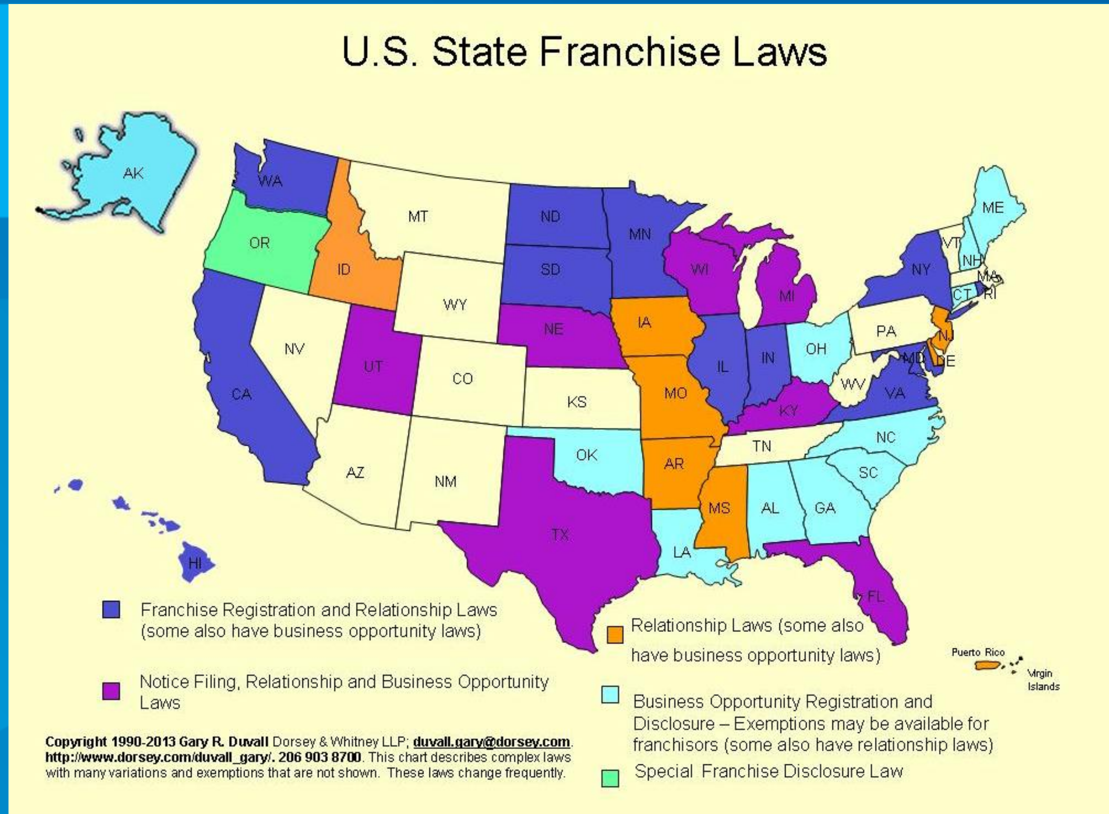
# THE BASICS INCLUDE:

1. The FTC rule;

2. A variety of state statutes addressing the sale of franchises and business opportunities;

3. Statutes in several states that restrict or control the ability of a franchisor to terminate or refuse renewal of a franchise or regulate other aspects of the relationship between franchisee and franchisor (the so called "state franchise relationship laws"); and

4. Industry specific statutes and regulations maintained by both Federal and state governments in particular businesses such as auto dealers, farm implement dealers or gasoline dealerships.




**State Offices Administering Franchise Disclosure Laws**

Fifteen states have franchise investment laws that require franchisors to provide pre-sale disclosures, known as a "Franchise Disclosure Document," to potential purchasers. Thirteen of these state laws treat the sale of a franchise like the sale of a security. They typically prohibit the offer or sale of a franchise within their state until a franchise offering circular has been filed on the public record with, and registered by, a designated state agency. Two of the fifteen states do not require a filing of offering circulars, as noted in the list of state offices below.

These state laws give franchise purchasers important legal rights, including the right to bring private lawsuits for violation of the state disclosure requirements.

**California**, **Hawaii**, **Illinois**, **Indiana**, **Maryland**, **Michigan**, **Minnesota**, **New York**, **North Dakota**, **Oregon**, **Rhode Island**, **South Dakota**, **Virginia**, **Washington**, **Wisconsin**

# PURPOSE AND PUBLIC POLICIES UNDERLYING FRANCHISE LAWS

- Ensuring relatively equal bargaining power between suppliers and distributors.
- Ensuring fairness and equity in the supplier/distributors relationship.
- Protecting distributor equity from arbitrary and capricious termination.
- Alcohol franchise laws have the additional regulatory purpose of supporting three-tier and tied-house laws.

# Ensuring Fairness and Equity in the Franchisor/Supplier and Franchisee/Distributor Relationship

- Franchisors/suppliers require franchisees/distributors to make certain financial, marketing, and advertising commitments in order to create or broaden distribution.
- Fulfilling these commitments involves a substantial investment of capital and personnel on the part of franchisees/distributors.  Franchisees/distributors typically make long-term legal commitments, usually in facility build-outs and multi-year lease and equipment agreements, to meet their contractual commitments.
- Franchise laws prevent undue usurpation of that substantial investment and prohibit the arbitrary and capricious termination of distribution rights.

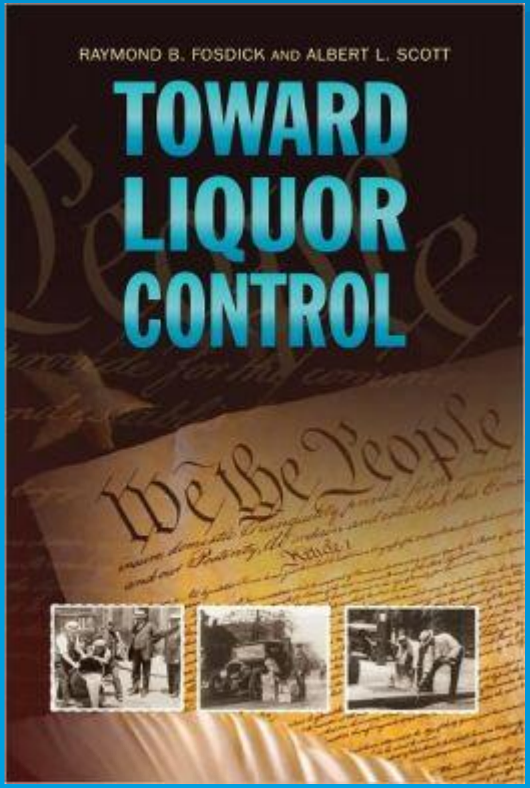
# SUPPORTING THE THREE-TIER SYSTEM

- While change is inevitable, consolidation within the beer industry may have disturbing and harmful consequences to effective alcohol regulation.
- The architects of our current regulatory systems understood that locally-based sellers of alcohol were likely to be more responsive to community norms and standards and more responsible with regard to their sales and promotion practices.
- As noted in Fosdick & Scott,

"The 'tied house' system had all of the vices of absentee ownership. The manufacturer knew nothing and cared nothing about the community. All he wanted was increased sales. He saw none of the abuses, and as a non-resident he was beyond local social influence. The 'tied house' system also involved a multiplicity of outlets, because each manufacturer had to have a sales agency in a given locality. In this respect the system was not unlike that used now in the sale of gasoline, and with the same result: a large excess of sales outlets. Whether or not this is of concern to the public in the case of gasoline, in relation to the liquor problem it is a matter of crucial importance because of its effects in stimulating competition in the retail sale of alcoholic beverages.

Fosdick and Scott, Toward Liquor Control *at 43 (*Hansen & Bros. Publishers 1st Ed. 1933).

# Additional Public Policy and Purpose Underlying Alcohol Franchise Laws




- The architects of our current regulatory system also understood that vertical integration of the industry, and the creation of monopolies at any industry tier, threatened the effective regulation of alcohol. Such integrated entities, in practical terms, could grow so powerful that they would be beyond the reach of effective regulation.

- As a result, the most essential feature of our alcohol regulatory structures is the three-tier system, which divides the industry into a brewer, distributor, and retailer tier, each restricted to its own service focus.

# Additional Public Policy and Purpose Underlying Alcohol Franchise Laws

- The efficacy of the three-tier system was recently recognized in *Manuel v. State of Louisiana:*

"Without the three-tier system, the natural tendency historically has been for the supplier tier to integrate vertically. With vertical integration, a supplier takes control of the manufacture, distribution, and retailing of alcoholic beverages, from top to bottom. The result is that individual retail establishments become tied to a particular supplier. When so tied, the retailer takes its orders from the supplier who controls it, including naturally the supplier's mandate to maximize sales. A further consequence is a suppression of competition as the retailer favors the particular brands of the supplier to which the retailer is tied to the exclusion of the other suppliers' brands. With vertical integration, there are also practical implications for the power of regulators. A vertically integrated enterprise -comprising manufacture, distribution, and retailing - is inevitably a powerful entity managed and controlled from afar by non-residents.

The three-tier system was implemented to counteract all these tendencies. Under the three-tier system, the industry is divided into three tiers, each with its own service focus. No one tier controls another. Further, individual firms do not grow so powerful in practice that they can out-muscle regulators. In addition, because of the very nature of their operations, firms in the wholesaling tier and the retailing their have a local presence, which makes them more amenable to regulation and naturally keeps them accountable. Further, by separating the tiers, competition, a diversity of products, and availability of products are enhanced as the economic incentives are removed that encourage distributors and retailers to favor the products of a particular supplier (to which distributor or retailer might be tied) to the exclusion of products from other suppliers."

*Manuel v. State of Louisiana*, 2008 WL 1902437 (April 30, 2008 La. App. 3 Cir.) (rejecting an antitrust challenge to state liquor laws).

# *CURRENT RELEVANCE OF THE THREE-TIER SYSTEM*

- The threat of vertical integration is greater today than at any time since prohibition.
- Two foreign-owned companies now control over 80% of the American beer market.
- One company, ABI, has expressed its intent to dramatically increase their branch volume from the current 7% to 25% or even 50% of its volume.
- The other company, MillerCoors, has expressed its intent to significantly consolidate its distribution network and have, in fact, taken significant steps in achieving that goal.

# How Alcohol Franchise Laws Support the Three-Tier System & Tied-House Laws

- The Three-Tier System and Tied-House laws have worked remarkably well for over 75 years.
- As recently as three years ago, the United States Supreme Court noted that "the three-tier system itself is unquestionably legitimate." *Granholm v. Heald*, 544 U.S. 460, 488-89 (2005).
- It is impossible to have an effective three-tier system and tied house ban without separating the industry into three tiers and without safeguarding the independence of the middle tier. Beer Franchise Laws safeguard the independence and relative bargaining power of distributors vis-à-vis suppliers and thereby ensure that distributors may fulfill their public policy functions of serving as a buffer between suppliers and retailers, preventing vertical integration of the industry, and ensuring local control and accountability of alcohol distribution channels.

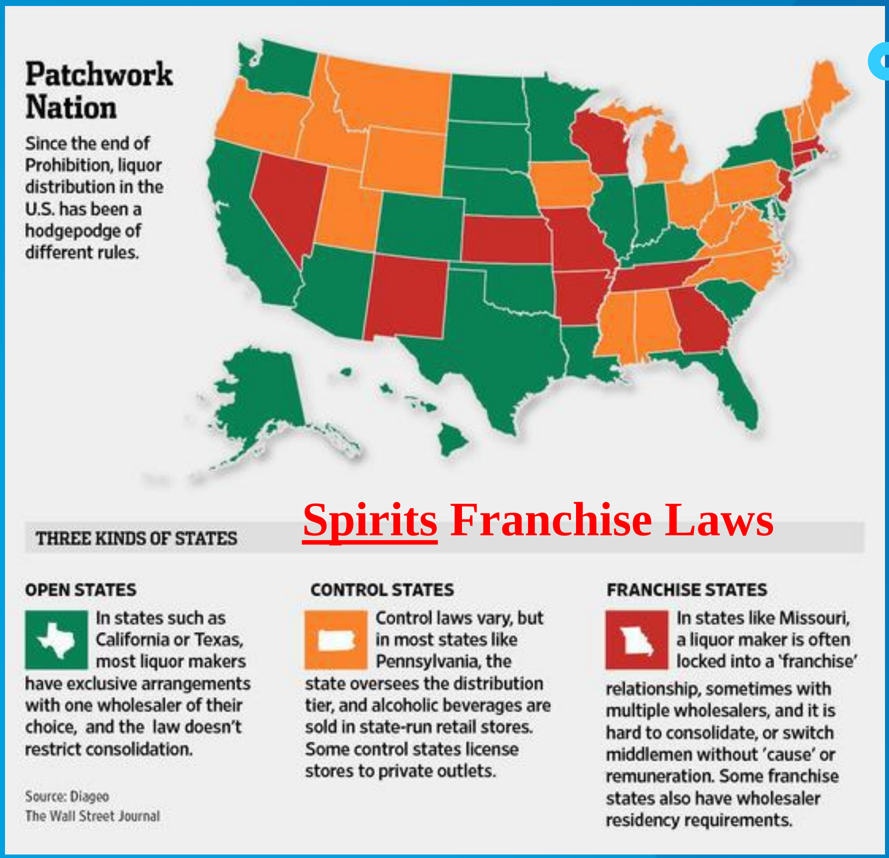
# Franchise Laws are Remedial Legislation

- All franchise laws are remedial legislation designed to prevent franchisor/supplier abuses and inequity.
- Alcohol franchise laws are remedial to even a greater degree because of their regulatory purpose under the 21$^{st}$ Amendment .
- As remedial legislation, franchise laws, and in particular alcohol franchise laws, "should be given a liberal construction to effectuate its statutory purpose." *Arneson Distributing Co., Inc. v. Miller Brewing Company*, 117 F.Supp.2d 905 (D. Minn. 2000).
- Furthermore, any ambiguity should be resolved in favor of the distributor and the underlying purposes of the Law.

# ENSURING FAIRNESS AND EQUITY IN THE SUPPLIER/distributor RELATIONSHIP

- Supplier require distributors to make certain financial, marketing, and advertising commitments in order to create or broaden distribution.
- Fulfilling these commitments involves a substantial investment of capital and personnel on the part of distributors.  Distributors typically make long-term legal commitments, usually in facility build-outs and multi-year lease and equipment agreements, to meet their contractual commitments.
- Beer Franchise Laws prevent undue usurpation of that substantial investment and prohibit the arbitrary and capricious termination of distribution rights.

# Common Provisions of Alcohol Franchise Laws




- Over 30 states have beer franchise laws. 11 states have **spirits franchise laws**. Other states have general franchise laws, fair dealer laws, or common law that may apply to alcohol suppliers and distributors and may define the rights and obligations of suppliers and distributors.

# Common Provisions of Alcohol Franchise Laws

- <u>No Inducement or Coercion</u>
- <u>No Dual Distribution</u>
- <u>Brand Extension</u>
- <u>Notice of Intent to Terminate</u>
- <u>Termination of Distributor Agreements for Good Cause Only</u>
  - "Good cause" is often defined as a "failure by the distributor to substantially comply, without reasonable excuse or justification, with any reasonable and material requirement imposed on the distributor by the brewer, where the failure was discovered by brewer not more than one year before the date on which the brewer gave notice to the distributor."
- <u>Obligations of Succession</u>
- <u>Assignment, Transfer, or Sale of Business</u>

# Common Provisions of Alcohol Franchise Laws

- No Discrimination
- Price of Product
- Retaliatory Action Prohibited
- No Waiver
- Right of Free Association
- Judicial Remedies

*In the beverage alcohol industry, what you call it depends upon who you are.*

**Suppliers:**
**Monopoly Protection**

**Craft Brewers:**
**Market Access restrictions**

**Wine/Beer/Spirits Wholesalers:**
**Franchise Laws**

DISTILLED SPIRITS COUNCIL OF THE UNITED STATES

*[From DISCUS Summary of State Laws]*

"Monopoly protection" refers to state laws which provide wholesalers with rights not provided in their contracts with producers. The term "monopoly protection" is used in lieu of "franchise" because the latter is a misnomer when applied to distilled spirits distributorships.

NBWA National Beer Wholesalers Association

*Franchise laws provide beer distributors with independence and work to prevent chain accounts from dictating terms, often at the expense of small retailers. State laws, including franchise, allow independent distributors to better serve independent retailers.*

National Beer Wholesalers Association President & CEO

Craig Purser, Fall 2013 Insider Column

www.nbwa.org

BA BREWERS ASSOCIATION

**Franchise Laws/Access to Market**

**Brewers Association - believes that small brewers and wholesalers should be free to establish enforceable contracts between the parties that both parties agree are fair and equitable. Franchise laws were enacted to protect wholesalers from the undue bargaining power of their largest suppliers. Applying those laws to the relationship between a small brewer and the wholesaler is unfair and against free market principles. Where franchise laws exist, the BA believes that any brewer contributing a small percentage of a wholesaler's volume should be exempted from those laws and free to establish a mutually beneficial contract with that wholesaler.**

# Examples of Wine & Spirits Laws





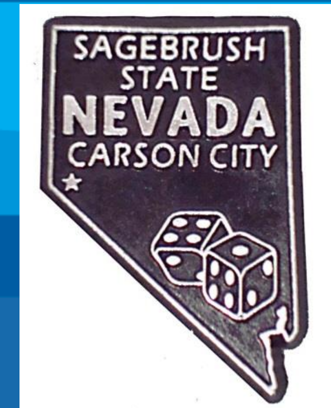
# *Can you terminate if a supplier reorganization or a shifting of brands ? Is that good cause ?*

The U.S. District Court for the Southern District of Ohio stated: "The [Ohio Alcoholic Beverages] Franchise Act grants Ohio beer and wine distributors unique protections." These laws, the franchise laws, limit the ability of a manufacturer to terminate a wholesaler's contract. The franchise laws strengthen the wholesalers' ability to withstand pressure from manufacturers and retailers to increase sales. These sets of laws and regulations are designed to prevent undesirable marketing practices among manufacturers and wholesalers resulting in disruption of the orderly marketplace and ultimately to abusive consumption.

Ohio courts have interpreted the Act as “demonstrat[ing] clear legislative intent to deny manufacturers the ability to terminate franchises due to corporate reorganizations or the shifting of brands among entities under common control.” Beverage Distribs., Inc. v. Miller Brewing Co., Nos. 2:08–cv–827, 2:08–cv–931, 2:08–cv–1112, 2:08–cv–1131, 2:08–cv–1136, 2:09–cv–0022, 2009 WL 1542730, *2 (S.D.Ohio June 2, 2009) (quoting InBev USA LLC v. Hill Distrib. Co., No. 2:05–CV–00298, slip op. at *13 (S.D.Ohio Apr. 3, 2006)).

BEVERAGE DISTRIBUTORS INC
v. MILLER BREWING COMPANY
PLC LLC No. 11–3484. Argued:
May 29, 2012. -- August 16, 2012
US Ct.Appls 6th cir.

# *OPPOSING VIEW*




American Mart Corp., Plaintiff-Appellant/Cross-Appellee, v. Joseph E. Seagram & Sons, Inc., Defendant-Appellee/Cross-Appellant., 824 F.2d 733 (9th Cir. 1987)

“The district court held that "good cause" exists where "in the exercise of prudent business judgment the supplier terminates the franchise on grounds that are truly legitimate and are not arbitrary, capricious, irrational, unreasonable or irrelevant," whether or not the distributor is at fault.... Thus, neither the good cause nor the good faith provisions of the Nevada statute bars Seagram's actions.”


# *Missouri Beverage Co., Inc. v. Shelton Bros. Inc.,* **2001 WL 2458069 (W.D. Mo. June 17, 2011).**

- This case arose out of the termination in 2010 of a relationship between Shelton Brothers, a supplier of artisanal beers, and Missouri Beverage Co, a Missouri beer distributor. The relationship was based on an oral agreement reached in 2004.

- The primary issue involved in the dispute was whether the relationship between the parties was a "**franchise**" within the meaning of **Mo. Rev. Stat. §407.400**. If it was a "franchise", Shelton Brothers would be required to demonstrate "good cause" to terminate. If it was not a "franchise", Shelton Brothers would be entitled to terminate for any reason or no reason at all.

# Missouri Beverage Co vs. Shelton Bros: The Dispute

- Specifically, the central dispute was whether §407.400, as applied to beer suppliers and distributors, applied to any relationship between a beer supplier or distributor [which is true of most beer franchise laws] or whether it only applied to such a relationship "in which there is a **community of interest** in the marketing of goods or services at wholesale, retail, by lease agreement or otherwise." Expressed another way, the issue was whether the definition of "franchise" was broader as applied to the liquor industry by virtue of a 1975 amendment to §407.400 or whether the definition was more restrictive as with other industries.

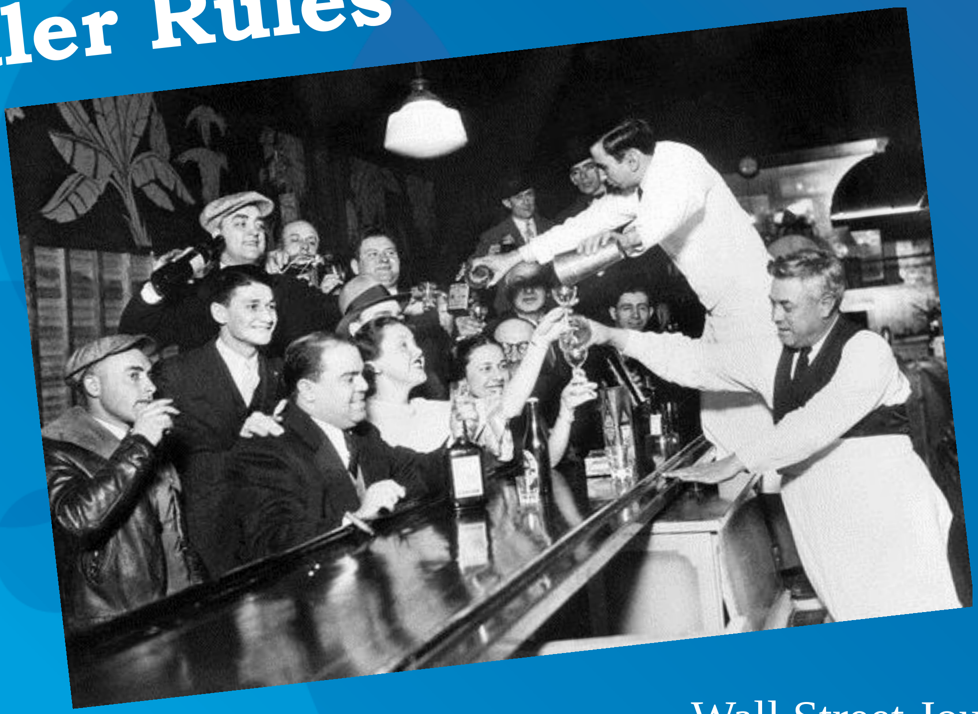
# Missouri Beverage Co vs. Shelton Bros: The Decision

- The District Court found for Shelton Brothers and **held that a party must prove that the relationship meets both the general and liquor-specific definitions of "franchise" contained in §407.400**. Therefore, in order for §407.400 to apply, a beer distributor must prove the following:
  - that the parties have entered into a written or oral agreement
  - that the supplier has granted the distributor a license to use their trade name, trademark, service mark, or related characteristic
  - that there is a "community of interest" in the marketing of goods or services at wholesale, retail, by lease, agreement or otherwise and
  - that the beer distributor and supplier in question satisfy the statutory definitions embodied in Chapter 311.
- Based upon cross motions for summary judgment, the **Court held that Shelton Brothers never granted Missouri Beverage a license to use its trademark, that Missouri Beverage's investments were not "franchise-specific", and that it was not required to make such investments by agreement or otherwise**. Accordingly, the Court concluded that there was no "community of interest" and that §407.400 did not apply.

# Missouri Beverage Co vs. Shelton Bros: The Appeal

- On appeal, the 8th Circuit Court of Appeals affirmed the District Court.
- The Court noted that the 1975 amendment to §407.400 added an express inclusion of liquor wholesalers and suppliers into the definition. The Court further noted, however, that the 1975 amendment did not change the original three requirements for a franchise to exist (i.e. an agreement, a license to use trademarks, and a "community of interest"). Finding the statute to be clear and unambiguous, the Court held that the original three requirements must be met in order for the franchise law to apply to a liquor wholesaler.
- The Court then examined the record to determine whether Missouri Beverage had been granted a license to use Shelton Brothers trademarks and whether a community of interest existed. Based upon that record, the Court concluded that these requirements were not satisfied. Particularly with regard to the "community of interest" requirement, the Court relied upon case law in New Jersey and Wisconsin, which had similar "community of interest" requirements.

# Diageo Leads Booze Brawl in Missouri Distillers Fighting To Overturn 1930s Wholesaler Rules



Wall Street Journal
June 27, 2013

# Major Brands vs. Diageo

- Following the Shelton Brothers case, several terminations of distribution rights ensued in Missouri.

- Accordingly, the case accelerated consolidation at the distribution tier in the Missouri market. This has implications for liquor regulators.

- In the subsequent ***Major Brands vs. Diageo*** **case, the court adopted a similar interpretation of Mo. Rev. Stat. §407.400 and but interpreted "community of interest far more broadly and held that a community of interest indeed existed under the facts of that case**. The court refused to issue an injunction, however, enjoining Diageo from terminating distribution rights. Rather, the court held that the appropriate remedy would be an award of damages (i.e. fair market value of the distribution rights).

# Major Brands vs. Diageo

In pertinent part, the court held:

> "Partly as a result of the manner of regulation of distribution of alcoholic beverages in many states, such as Missouri, **the relationship between a liquor manufacturer or supplier and its distributors can be highly interdependent. Suppliers and distributors are alike dependent on the success of promotions of particular brands of alcoholic beverages for their profits. Many promotions are undertaken by the distributors at retail outlets or sponsored events; most advertising is handled by the suppliers, with financial contributions from distributors. Although distributors themselves are seldom, if ever, identifiable by the consuming public, as a matter of fact there often exists a very strong community of economic interest between liquor suppliers and their distributors.** In the case of Major Brands and Diageo, the Court finds that there is indeed such a community of interest."